

NEW LANDING UTILITY, INC.

ILLINOIS  
COMMERCE COMMISSION

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Direct Testimony of  
GENE L. ARMSTRONG  
(September 20, 2004)

In Support of Request for General Increase  
in the Rates for Water and Sewer Services

Q 1: What is your name and address?

Ans. Gene L. Armstrong. My office address is 1111 South Blvd., Oak Park, Illinois 60302

Q 2: What is your relationship to New Landing Utility, Inc. ("NLU")?

Ans. I am President of NLU. I have been President since June, 1984.

Q 3: What is NLU?

Ans. NLU is an Illinois corporation. It holds a Certificate of Public Convenience and Necessity to provide water and sewer services in a service territory located in Taylor Township, Ogle County, Illinois. It has been providing water and sewer services in its certificated service territory since the effective date of its initial rates, rules, regulations and conditions of service: February 15, 1980.

Q 4: What is DAME Co.?

Ans. DAME Co. is an Illinois corporation. It holds all of the stock issued by NLU.

Q 5: What is your relationship to DAME Co.?

Ans. I am President of DAME Co. I hold all of the stock issued by DAME Co.

Q 6: Are you employed by NLU?

Ans. No. NLU has no employees. The people who provide management and operations services for NLU are independent contractors.

Q 7: Does NLU pay you for your services as President?

Ans. No.

Q 8: By whom are you employed?

Ans. I am employed by my law firm: Gene L. Armstrong & Associates, P.C. I am President. I am the majority shareholder.

Q 9: Are you engaged in the practice of law?

Ans. Yes. Since 1967, I have been licensed to practice law in the State of Illinois. My law firm concentrates in civil litigation at all levels and in all courts in Illinois. In addition to litigation, my practice encompasses Illinois public utility law, water and sewer, and local zoning law.

Q 10: What part of your time at the law firm is devoted to the different aspects of your practice?

Ans. As to the time committed to practice of law, typically, approximately ninety percent of my time would be devoted to litigation. The remaining ten percent would be devoted to utility law, primarily NLU, or municipal law, primarily local zoning cases.

Q 11: Why do you say "typically?"

Ans. The last three years have not been typical in this respect. I have devoted substantially more of my law practice time to public utility law. The most significant factor is the lawsuits the Illinois EPA filed against NLU. My work on those cases has been civil litigation, but civil litigation related to public utility law. In addition, for the past year or so, I have devoted more time to the legal issues that pertain to NLU's efforts to obtain a rate increase. By contrast, my work as President of NLU is separate and apart from the time my law firm (through me) has devoted to the legal issues that pertain to NLU's effort to secure rate relief.

Q 12: What is your educational background?

Ans. I attended the University of Wisconsin in Madison. I received a Bachelor of Science degree in 1963, and a Masters of Science degree in 1964. My major was economics. In 1964, I entered law school at Stanford University, Palo Alto, California. I received an LL.B. in 1967.

Q 13: How long have you worked in Illinois public utility law?

Ans. More than thirty years.

Q 14: What is the scope of that work?

Ans. I worked on Commerce Commission cases for Commonwealth Edison. I also worked on

Commerce Commission matters for many different water or water and sewer utilities. The work covered the wide range of requests for Commission approval or relief, including rate relief, approval of agreements with affiliated interests, requests for certificates of public convenience and necessity, approval of financial structures, authority to issue securities, determinations of original cost of plant facilities.

Q 15: What is CAM Properties?

Ans. CAM Properties is an Illinois partnership. CAM owns the building at 1111-1113 South Blvd., Oak Park, Illinois. I am the majority partner. My law firm rents office space in that building. In recent years, NLU has rented space in the building, and presently rents a small office on the second floor.

Q 16: Can you describe your work as President of NLU?

Ans. Yes. As President of NLU, I am involved in all aspects of the business side of NLU. I am not involved in the operation of the water system or the sewer system. One must be certified by the Illinois EPA to be the operator of those systems. I am not certified. NLU retains the services of certified operators for its water facilities and for its sewer facilities. As President of NLU, I make arrangements for those certified operators to provide services to NLU.

Q 17: Does DAME Co. provide services to NLU?

Ans. Some. The Management Services Agreement that was approved by the Commerce Commission provides that, to the extent practical, services needed by NLU should be obtained under contracts between NLU and the service provider. There are management services that DAME Co. provides, through me, that are in addition to the services NLU obtains under the agreements it has with independent contractors. Most of these services fall into the category of policy and planning assistance and advice. Again, to the extent such services are being provided, I am the person who is involved. I am not paid by DAME Co. for any services I provide to DAME Co., or to NLU through DAME Co.

Q 18: Can you describe the business of NLU?

Ans. Yes. NLU provides metered water service to approximately 310 residential customers. About half of these customers reside in the New Landing for the Delta Queen Subdivision ("New Landing") and almost all of the rest reside in the Lost Nation Lake Subdivision ("Lost Nation"). We also serve homes constructed in Lakewood Greens, Knollwood and Flagg Estates. These areas were subdivided more recently. At this time, there are fewer than twenty homes, total, in these areas. Most of the residences we serve are year-round homes, but some are recreation homes and are occupied only part of the time.

NLU provides sewer service to approximately 160 residential customers. Generally speaking, the water service customers in Lost Nation are not sewer service customers.

NLU also serves approximately 690 availability charge customers. These customers own vacant lots in New Landing. NLU charges a monthly rate for the availability of water service and a monthly rate for the availability of sewer service.

At this time, NLU serves no commercial, institutional or industrial customers. This seems unlikely to change in the foreseeable future.

Q 19: What is the purpose of your testimony in this case?

Ans. My purpose is to explain to the Commission why NLU has requested a general increase in its rates for services, and why it asks the Commission to establish the new rates and the new rules, regulations and conditions of service set forth in the schedules NLU filed on March 11, 2004. I will compare the proposed rates to the present rates. I will describe the new rates that NLU requests and explain why NLU asks the Commission to approve the new rates. I will discuss the factors that I believe should be considered in respect to the rates and revenue requirements for NLU. In this respect, I will discuss financial conditions and circumstances, rate structures, rates of return, plans to renovate or replace plant facilities and other relevant factors. I will also describe and explain the exhibits I prepared.

Q 20: Can you describe NLU's present rate structures?

Ans. The presently-effective rates, rules, regulations and conditions of service were established by the Commerce Commission in 1980. They are the original rates for NLU. They became effective on February 15, 1980. The current filing is the first request that NLU's rates be increased or its rules changed. We have operated under the initial rate schedules for twenty three years.

Q 21: How do the proposed rates compare to the present rates?

Ans. A more detailed comparison is set forth in NLU Exhibit PN. I prepared Exhibit PN. It is comprised of three documents. A copy of the public notice NLU published in the Sauk Valley Newspaper to inform people of the filing of this request for a general rate increase; a copy of the certificate of publication, and a copy of the Public Notice NLU posted at conspicuous locations in its service territory and at its office in Oak Park, Illinois. In summary form, the comparison of the present and the proposed rates, as monthly charges for customers served by 5/8-inch meters is as follows.

<u>Type of Service</u>	<u>Present Monthly Charge</u>	<u>Proposed Monthly Charge</u>
<i>Metered Water Service</i>		
Minimum Bill	\$10.00	\$30.00
Use charges (per 1,000 gals)		
Present rates:		
First 20,000 gals	\$ 1.70	
Next 100,000 gals.	\$ 1.50	
All over 120,000 gals	\$ 1.30	
Proposed rates:		
First 9,000 gals		\$ 3.40
Next 11,000 gals		\$ 3.20
All over 20,000 gals		\$ 3.00
<i>Outside Meter Reading Device</i>	\$ 0.33	none
<i>Metered Sewer Service</i>		
Multiple of metered water bill	1.2 times	1.2 times
Minimum Bill	\$12.00	\$36.00
<i>Availability of Water Service</i>	\$ 4.50	\$13.50
<i>Availability of Sewer Service</i>	\$ 4.50	\$13.50

I believe all of our customers are served by 5/8-inch meters. I expect NLU will convert from quarterly to monthly billing.

Q 22: Why does NLU seek rate relief at this time?

Ans. There are several reasons:

First: NLU has relied on the same rates for more than twenty three years. Our rates no longer generate revenue sufficient to pay our suppliers on a timely basis. This is true without consideration of the extraordinary litigation expenses we have incurred, a matter that I discuss in more detail, below. NLU relies on its suppliers for chemicals, lab testing services, repair services, installation services, and many other operational needs. It is increasingly difficult to keep current with payments to the suppliers. They have been patient with us, but we cannot plan to operate on the basis of the "kindness of strangers." We must be able to pay our bills. The substantial increase in our accounts payable account is due only in part to the past-due legal fees we have incurred. NLU also owes those who provide repair and installation services and provide other goods and services it

needs to conduct day-to-day operations and pay its other obligations.

Second: We must renovate or replace major plant facilities.

*Water Storage Tower:* Our water storage tower must be either renovated or replaced. It has not been painted in at least thirty years. Recently, it has been inspected by two competent, independent professionals: Utility Services Company in 2002 and Dixon Engineering in 2004. While the storage tower needs extensive work, the inspectors have declared it to be in good condition, all things considered. We are assured that we do not yet face an emergency, but we are advised to set a plan of action as soon as practicable. The storage tower can be renovated and provide years of service. However, it may be wiser to replace this tower with one of a more modern design, or with a standpipe rather than an elevated storage tank. The proposal to renovate the tower is submitted as NLU Exhibit WTC. We have one comparison of the cost to replace rather than renovate the tower. We await additional proposals. In any event, however, it is certain that the cost to renovate or replace the water tower will be no less than \$250,000 - \$300,000. We must proceed as soon as possible, but we cannot proceed unless we have new rates that justify a belief that we will receive revenue sufficient to pay for the work. Our present financial circumstances make it impossible to proceed.

*Sewage Treatment Plant:* This is the other pressing renovation project. The plant is more than thirty years old. We have been advised that the aeration systems should be replaced, that the backup generator should be replaced and that it may be necessary to install additional treatment systems. We are exploring alternative treatment technologies. We are asking for proposals. However, we lack the resources to commission an engineering study as to the preferred approach to renovation of the sewerage treatment plant. We know it must be done, and we know that we should proceed as quickly as we can. We expect the cost will be no less than \$250,000 - \$300,000. Again, however, until we know that we can count on rate revenue sufficient to pay for the work, it is impossible to proceed even with an engineering study which would be preliminary to any decision as to renovation work NLU would undertake to perform.

Third: We need funds to pay the costs we have incurred, and will incur, to defend against lawsuits filed by the Illinois EPA. There are already two such suits on file. I have reason to expect a third suit will be filed as to renovation of the sewer plant (discussed below). The costs to defend are staggering, to say the least. Based on my analysis of the reasons for these suits, I believe these costs are unavoidable. I wish to share my views regarding these lawsuits.

*People ex rel Illinois EPA v New Landing Utility, Inc., et al* No 00 CH 97. This suit is still pending. The trial concluded at the end of January, 2004. The parties agreed to submit written summations. All written summations were filed by May 25, 2004. The Judge has taken the matter under advisement and will announce his decision at a later date. It seems unlikely that a decision will be announced before mid-June, at the earliest.

There are fifteen separate counts in this suit. After the decision is announced, there is a likelihood that one or more of the parties may move for reconsideration or clarification of the decision. The resolution of motions to reconsider could take several weeks. In my view, there is a likelihood that one or more of the parties will appeal at least some part of the decision, regardless of how motions to reconsider or clarify are resolved. Appeals would take several months, probably more than a year. The costs to prepare and try the case, and to prepare the written summation, have already been incurred. Additional cost will be incurred in respect to motions to reconsider or clarify the decision, or in respect to any appeal from the decision. Before the case is finally resolved, legal fees are almost certain to exceed \$250,000. Because this is a pending case, I will limit my comment to one observation: For several years NLU has been willing to do everything the EPA asked in this case. Settlement was never possible, however, because the EPA always insisted that, in addition to the undertakings that are the subject of this case, NLU was legally obligated to replace the old, problematic water lines that were installed in the south half of Lost Nation before NLU was incorporated. NLU never agreed that it was obligated to replace the old water lines in the south half of Lost Nation. For a more complete understanding of NLU's position in respect to each of the fifteen counts in this case, the Written Summation submitted by NLU (and the exhibits and transcripts NLU cited) is filed in this case as NLU Exhibit WS-1 and Exhibit WS-2. These are public documents that could be obtained from the court by anyone sufficiently curious to review the case file. I also wish to state that NLU has sent copies of its Written Summation (but not the exhibits and transcripts) to all of its customers.

*People ex rel Illinois EPA v New Landing Utility, Inc., at al No 04 CH 20.* This suit is also still pending. Its history is as follows: On Sunday, February 1, 2004, NLU discovered a small leak (about the size of a pencil) in the water storage tower. NLU immediately made arrangements for proper repair. On Tuesday, February 3, 2004, attorneys for the EPA, having been informed about the leak by NLU's certified water operator, demanded that NLU agree to the entry of a consent order in the case described, above. NLU, having already made all necessary arrangements for repair of the leak and refused to accede to the EPA's demand. On Wednesday, February 4, 2004, this suit was filed. The EPA sought an emergency injunction at a hearing scheduled for the morning of Thursday, February 5, 2004. The Court, being advised that repairs were in process at that very moment, continued the matter to the following Tuesday, February 10, 2004. At that time, the Court, being assured that repairs had been successfully completed on Thursday, February 5, 2004, and that the EPA had cleared the NLU water system for normal operation on Saturday, February 7, 2004, refused the EPA's request for an emergency injunction. It appeared that all matters were resolved except for the EPA's demand that NLU obtain an inspection of the storage tower. In the hope that litigation costs could be avoided, NLU agreed to arrange for an inspection. The Inspection Report was shared with the EPA. NLU's effort to avoid litigation costs failed; the EPA persisted in its effort to obtain the preliminary injunction. At that point, two parts of the requested relief were unresolved: (1) The EPA's demand that the engineer certify that the water tower was safe

for operation at full capacity, and (2) the EPA's demand that Gene Armstrong deliver two gallons of drinking water to each customer each day any boil order might be in effect. (The boil order issued on February 5, the date the repair was made, was lifted, on February 7, the date the EPA accepted as satisfactory the water sampling results submitted by NLU.) A hearing on the EPA's motion for a preliminary injunction was held on May 10, 2004. At that time, NLU presented a certificate of the professional engineer who signed the Report which confirmed that the tower could be operated "at full capacity." Thus, the only unresolved issues was the EPA's demand that Gene Armstrong personally deliver drinking water to NLU's customers. Still, the EPA persisted. Thus, a hearing was held on the EPA's request for a preliminary injunction. (The engineer who signed the report and the certificate also testified to this fact at the court hearing.) At the close of the hearing, the court refused to issue a preliminary injunction. By agreement of the parties, this case was continued to June 7, 2004. At that time, the EPA expects to be in a better position to determine what course of action it will follow in respect to this case. The legal fees incurred to date are approximately \$15,000. The consulting engineer's charge for the inspection and report, and for appearing as a witness on May 10, 2004, are likely to be in the range of \$5,000. At this date, it is not possible to anticipate what additional litigation costs and fees may be incurred.

*EPA v. NLU - Sewer Plant Case.* Comments by counsel for the EPA give NLU reason to believe that the EPA may file suit to request a court order that would compel renovation of the sewer plant (at least to the extent described above). At this point, it is difficult to predict what litigation costs and fees would be incurred to defend against such a suit. It is possible to say, however, that if the EPA insists upon the form of onerous "consent judgment" that it has insisted upon as a condition of settlement in the prior cases, resolution by settlement will be impossible. As such, significant legal fees and litigation costs would be incurred.

Fourth: NLU needs funds to pay debts previously approved and authorized by the Commission. These obligations arise from the Order the Commission entered in ICC Docket 79-0675. The present rates have never generated enough revenue to enable NLU to pay these obligations. As such, these obligations have been accrued and are still owing. Three of these obligations are reflected on the financial exhibits I have prepared.

*The Mortgage Note - Principal.* The Commission authorized NLU to issue its Mortgage Note in the principal amount of \$170,534. Semi-annual installments due were never paid. Instead, they were accrued. As the balance due recorded for the Mortgage Note decreased, the amount due as Accounts Payable to Associated Companies increased by like amount. As such, the entire principal amount due remains unpaid

*The Mortgage Note - Interest:* For the same reason, substantially all of the interest that became due on the Mortgage Note was not paid. Instead, it was accrued. As of December 31, 2003, this accrued interest due totaled \$430,273.



*The Letter Agreement.* The Commission authorized NLU to enter into and perform a Letter Agreement which obligated NLU to pay \$2,000 for each home attached to the system during the period ending January 1, 1991. The total due was accrued for the reason that rate revenues were never sufficient to permit payment to the creditor. The total due under the Letter Agreement is \$248,000. The balance of the \$300,000 limit of the Letter Agreement (\$52,000) is recorded in Account 252: Advances for Construction. It is no longer subject to repayment.

Fifth: We need rates that give NLU some hope that it will have at least the opportunity to earn a reasonable rate of return on its rate base - the value of the property it has committed to provide water and sewer utility services.

Q 23: Did you prepare the schedules that NLU filed with the Commission in March, 2004?

Ans. Yes.

Q 24: Can you describe the important changes reflected in the proposed rates?

Ans. Under the proposed rates:

The minimum bill metered services, water and sewer, will triple. In the rate bracket that will apply to our present customers, the use charge per 1,000 gallons will double. We would expect that the bill to an average customer will triple. We would expect that most metered customers would be charged the minimum bill.

The charges for availability of services, water and sewer, will triple.

The charge for an outside meter reading device will be eliminated.

Q 25: NLU seeks permission to impose a surcharge on certain customers. Can you explain the reason for the surcharge?

Ans. Yes.

NLU seeks permission to add a surcharge to the water bills rendered to customers who receive water through a main that was not installed by or for NLU. The proposed surcharge is \$7.50 per month. We believe 88 customers will be subject to the surcharge. All live in the south half of Lost Nation. The addresses of these customers are listed on NLU Exhibit SMRC. I prepared NLU Exhibit SMRC. They all receive water service through the old, problematic water lines that were installed in the south half of Lost Nation before NLU was incorporated. NLU incurs substantial and continuing costs to repair these lines. The line breaks in this area are far more frequent than in any other part of the NLU water distribution system. The cost to serve in this area is comparatively

high. The surcharge is intended to recognize this difference in the "cost to serve." It is expected to produce revenues that will be sufficient to pay for the frequent repairs, and to recoup, over time, a portion of the additional costs to serve this area that have been incurred over the past twenty three years. The surcharge is projected to produce \$660.00 per month (\$7,920 per year). This rate revenue is reflected in the financial exhibits I prepared.

Q 26: NLU seeks permission to impose a main replacement charge on certain customers. Can you explain the reason for the main replacement charge?

Ans. Yes.

NLU seeks permission to add a main replacement charge to the water bills rendered to customers who are subject to the surcharge. Again, these are the customers who receive water through a main that was not installed by or for NLU. The proposed main replacement charge is \$75.00 per month. We believe 88 customers will be subject to the main replacement charge. All live in the south half of Lost Nation. Again, the addresses of these customers are listed on NLU Exhibit SMRC. They all receive water service through the old, problematic water lines that were installed in the south half of Lost Nation before NLU was incorporated. Customers who receive water through these lines experience a range of service problems. Generally speaking, the service problems in this area do not occur in any other part of our water distribution system. NLU has long believed that replacement of these lines is the only way to resolve the service problems that plague this area. We know of no one who disagrees. For years, the EPA insisted that it could compel NLU to replace these lines - but now acknowledges that, legally, it was never able to compel NLU, or anyone else, to replace these lines. For years, representatives of the Lost Nation Property Owners' Association have tried to convince NLU to replace these problematic lines - with money mostly generated by bills NLU would collect from its customers in New Landing. For years, the customers in New Landing have objected to any plan by which they, in effect, "pay for" replacement of the old Lost Nation water lines. We propose the main replacement charge as a method NLU can use to achieve the result: replace these old lines. Receipts generated by the main replacement charge would be deposited to a restricted account to insure that these funds could only be used to replace these old lines. NLU is willing to select a representative from those subject to the charge to oversee the fund and to verify that receipts are accurately accounted for and deposited to the restricted fund. When the amount in the restricted account is sufficient to pay for the cost to replace these old lines, NLU will arrange for the work to be accomplished. When the new distribution mains are in place, we would expect that customers served by the old lines would be required to connect to mains that were "installed by or for the Company." When those connections are complete, no customer would be subject to either the surcharge, or, thereby, to the main replacement charge. Both the surcharge and the main replacement charge would, by their terms, cease. The main replacement charge is projected to produce \$79,200 per year.

This rate revenue is reflected in the financial exhibits I prepared. It is also subtracted from net income, as it will not be available to NLU for payment of any obligation. It will be deposited to the restricted account.

Q 27: Why not simply rely on the Commerce Commission Uniform Main Extension Rule as the mechanism to replace the old lines in the south half of Lost Nation?

Ans. This is the obvious solution. It has been used in all other parts of Lost Nation. But it has been the obvious solution for more than twenty-three years. Nothing has happened in the south half of Lost Nation. The existence and continuing use of these old lines is the underlying reason why NLU has been unable to settle the claims asserted by the Illinois EPA. As a consequence, NLU has incurred \$250,000 in litigation expenses. This is in addition to the costs to deal with the EPA's demands during the decade before the EPA filed suit in December, 2000. (The one factor that made all of these costs necessary was the EPA's continuing claim that it could compel NLU to replace the problematic water lines in the south half of Lost Nation - a claim it now acknowledges is simply not true.) It is our perception that no one has been willing to pursue other possible solutions. Therefore, NLU proposes this solution: Impose the main replacement charge and use the funds to solve this problem.

Q 28: NLU asks the Commission to establish a new rate: Rate 3 - a charge for the availability of service to a side yard lot. What is a "side yard lot" and how would Rate 3 apply?

Ans. This is explained in Paragraph 2. N. of the Definitions. It appears on Original Page 6 of proposed I.C.C. No. 5: The proposed Rules, Regulations and Conditions of Service for Water. Rate 3 pertains to customers who own lots subject to the availability charges. Experience shows that many of these customers own two or more adjacent lots, each subject to the availability charge. Some have constructed homes that extend across two lots. Others own an adjoining lot in order to preserve a desired open space - they never intend for a home to be constructed on the "side yard" next to their house. They have, in a real sense, created one lot out of two lots. Many of these customers have asked NLU to treat their two lots as one lot. Rate 3 is intended to accommodate this situation in a way that provides some relief for these customers yet preserves a part of the stream of revenue that makes it possible for these types of developments to exist. It is important to note that no metered customer may qualify more than one lot as a side yard lot. Where the metered service customer owns lots on both sides, all except the one designated as the side yard will still be subject to the regular availability charge rate. At this time, there are 80 customers who would pay Rate 3, the side yard rate. This anticipated revenue is reflected in the NLU financial exhibits.

Q 29: Does NLU also seek to change its reconnection charge?

Ans. Yes, we ask that the charge be increased to \$20.00. However, I wish to point out that we

have never had to disconnect a customer for any of the reasons where this charge would apply. No revenue related to this charge is included in the financial exhibits I prepared.

Q 30: Does NLU also seek to charge customers whose payment checks are dishonored?

Ans. Yes, we propose an NSF check charge of \$10.00. Again, I wish to point out that we almost never encounter problems with NSF checks. No revenue related to this charge is included in the financial exhibits I prepared.

Q 31: Are the Rules, Regulations and Conditions of Service proposed by NLU based on those suggested by the Commerce Commission staff?

Ans. Yes, and this is true for both water service and for sewer service. There are, however, a few differences. I have already explained the additional definition of a side yard lots. Most of the other changes would fall into the category of wording preferences.

I do want to highlight the proposed rule that allows the Company to recover attorneys fees if it must file suit against a customer who refuses to pay the amounts due under the rates for service or persists in a violation of the rules. This appears as Rule 22.E in the rules for water service (Original Sheet No. 30 in Ill.C.C. No. 5 and Rule IV.F. in the rules for sewer service (Original Sheet No. 10 in Ill.C.C. No. 6). This right to recover attorneys fees is very important. Without this right, the economics of a collection suit will continue to be very difficult, to say the least. Contingent fees are problematic in light of the relatively small amounts claimed due. Customers who are true "dead beats" or who have an incentive to avoid payment, and are experienced in ways to avoid payment (those who purchase lots for speculation, for example), exploit this reality. When such customers realize that the court has the authority to shift to them the legal fees NLU must incur to pursue collection, this opportunity to exploit the situation is greatly diminished. NLU feels that the cost to collect should be borne by those who refuse to pay rather than spread to the other customers who keep current on their bills. This rule will help NLU address this problem.

Q 32: What financial exhibits have you prepared?

Ans. I prepared the following financial exhibits:

NLU Exhibit CBS: Comparative Balance Sheet: 2000-2003

NLU Exhibit ISA - 1: Income Statement Analysis, Actual: 2001-2003

NLU Exhibit ISA - 2: Income Statement Analysis, Pro Forma 2004-2012

NLU Exhibit CRB: Comparative Rate Base Analysis

Q 33: Will you describe NLU Exhibit CBS?

Ans. NLU Exhibit CBS shows the balance sheet data for NLU for the years 2000, 2001, 2002 and 2003. The data is taken directly from the Annual Reports NLU filed with the Commission. The account numbers on the left are account numbers used in the Annual Report.

Q 34: How is this exhibit significant to this case?

Ans. It is especially significant in that it shows that the accumulated losses in the retained earnings account continue to grow. At December 31, 2003, the accumulated losses totaled \$1,285,289. Total equity capital was negative in the amount of \$385,289. These losses have accumulated over the past twenty-three years. There has never been a year in which NLU has realized a profit; we have always suffered losses. We need rates that will generate revenue sufficient to reverse more than two decades of losses, and enable NLU to earn a profit.

Q 35: Will you describe NLU Exhibit ISA - 1?

Ans. NLU Exhibit ISA - 1 shows the income statement data for NLU for the years 2001, 2002 and 2003. The data is taken directly from the Annual Report NLU filed with the Commission for each of these years. The account numbers on the left are account numbers used in the Annual Report.

Q 36: How is this exhibit significant to this case?

Ans. NLU Exhibit ISA - 1 shows the losses NLU suffered in each of these years. Review of all the NLU Annual Reports to the Commission would show that the Company has suffered losses in every year since 1980, the first year it was allowed to charge for the water and sewer services it provides. We simply must change this reality. Unless the rates increase to the point where the Company can earn a profit, I don't see how it will be able to continue operations.

Q 37: Will you describe NLU Exhibit ISA - 2?

Q 38: NLU Exhibit ISA - 2 shows the income statement data for NLU for the years 2004 to 2012. The data reflects pro forma results that could be expected assuming the proposed rates are in effect. The account numbers on the left are account numbers used in the Ill.C.C. Uniform System of Accounts and in the Annual Report. The income and expense amounts on this exhibit are, of course, estimates. Water results and sewer results are shown, as are total results.

Q 39: Can you explain the basis for the income estimates?

Ans. Yes. All income estimates are based on the assumption that the proposed rates were in

effect during the entire calendar year. Obviously, this will not be true in 2004, but the pro forma results are still informative. The following assumptions were also employed to generate the income estimates:

#### Unmetered Services (Availability Rates)

I assumed 690 availability charge customers for 2004. This number is reduced by two percent (2%) in each subsequent year. This adjusts for the fact that lot owners in New Landing continue to build homes. When a home is built and connected to the systems, the customer becomes a metered services account and ceases to be an availability charge account. The reduction translates to approximately 14 new homes each year. This would be affected by many economic factors that NLU cannot control, but it seems to me to be a conservative estimate (*i.e.*, it may be higher than what we will actually experience, based on the history of new homes built in recent years.)

#### Unmetered Services (Side Yard Rate)

I assumed 80 side yard customers in 2004. That is how many side yard situations we presently have. This number is increased by four percent (4%) in each subsequent year. It is not increased by the same percent as the estimate for metered service because we do not expect all new metered customers will build across two lots or own an adjacent lot. Our present experience is that slightly more than half of our metered service customers in New Landing are side yard lot situations. I expect that ratio to continue.

#### Metered Rates

I calculated the average of metered income reported in the years 2001-2003, multiplied by three and imposed a slight downward adjustment to reflect the assumption that people might try to use less water if rates were higher. Average metered water income for 2001-2003 was \$38,476. This average, times three is \$115,428. I rounded down to \$115,000. Average sewer income for 2001-2003 was \$22,259. This average, times three is \$66,776. I rounded down to \$65,000. These estimates for 2004 were increased by seven percent (7%) in each subsequent year. This translates to about 20 new homes each year. This construction would be expected in all parts of the service territory, not just in New Landing. Again, it seems to me to be a conservative estimate (*i.e.*, it may be higher than what we will actually experience, based on the history of new homes built in recent years.)

#### Forfeited Discounts (Late charges)

The amount shown for 2004 is slightly higher than three times the average of the prior three years (\$70,000 vs. \$64,650). I felt this higher estimate was reasonable under the circumstances. As a percentage of total income, the \$70,000 is slightly less than the

comparable calculations (average) for 2001-2003 (12.5% vs. 13.7%). I used the same estimate (\$70,000) in each subsequent year.

#### Surcharge

These amounts are the annual charge times 88 customers, the number of customers I count as being subject to the surcharge. No adjustments are made to these estimate for successive years.

#### Main Replacement Charge:

These amounts are the annual charge times 88 customers, the number of customers I count as being subject to the surcharge, and thus the main replacement charge. No adjustments are made to these estimate for successive years.

The receipts from the Main Replacement Charge are not really intended to be revenue NLU can use to pay its bills and obligations. These receipts are to be held in a separate, interest-bearing account. As such, they are not really "income" to NLU. The line "To Line Replacement Reserve" subtracts the Main Replacement Revenue from what would otherwise be counted as income to NLU. The balance is identified as "Adjusted Operating Revenue."

Q 40: Can you explain the basis for the expense estimates and other line items on this exhibit?

Ans. Yes. Certain assumptions were employed to calculate the line items that show the deductions from Operating Revenues to determine Net Income (Loss).

Operation & Maintenance Expenses: Except for the line items described below, all of these expenses were increased in successive years by an annual inflation factor of 3.32%. This is identified as part of the heading of this exhibit. According to the data reported by the U.S. Government in the *Statistical Abstract of the United States: 2003*, (123<sup>rd</sup> Edition), the Consumer Price Index, Urban, increased at the annual rate of 3.32% during the years 1990-2001.

1. Bad Debt Expense: Bad debt expense is calculated by reference to income estimates. Our bad debt estimates have always been related to particular classes of service. The bad debt expense for unmetered service is assumed to be twenty percent. The bad debt expense for metered service is assumed to be three percent. The changes in bad debt expense in successive years reflect this assumptions, they are not adjusted by the annual inflation factor.

2. Contract Services - Management: This expense is set by the terms of the Management Services Agreement the Commission approved in Ill.C.C. Docket

79-0675. There is no provision for inflation adjustments in that Agreement, and no inflation adjustment has been made to this expense.

3. Contract Services - Legal: The projected legal expenses reflect my estimates of the legal expenses NLU will incur to defend the suits that have been filed, and are expected to be filed, by the Illinois EPA. I anticipate that significant legal expenses will be incurred through 2007. The legal expenses shown for 2008 are, in my view, more typical of the legal expenses other small, independent water and sewer utilities would incur. No legal fees related to this rate case are included in the line items for legal expenses. Rate case expenses are reflected in the line item for amortization, discussed below.

Depreciation: NLU intends to continue to calculate depreciation expense by using the straight line method at an annual rate of 2%. This rate is applied to all depreciable property; NLU does not use a class-of-property depreciation methodology. Depreciation expense for our water plant is increased by \$5,000 in 2004 and subsequent years to reflect the cost for renovation or replacement of the water storage tower. (\$250,000 at 2% straight line depreciation is \$5,000/year.) Depreciation expense for our sewer plant is increased by \$5,000 in 2005 and subsequent years to reflect the cost for renovation or replacement of the sewerage treatment plant. (\$250,000 at 2% straight line depreciation is \$5,000/year.)

Amortization: Both water and sewer amortization expense is increased by \$5,000 (\$10,000, total) in 2005 to reflect amortization of the expenses NLU will incur in this rate case. I project that the costs NLU will incur through entry of the Commission's order in this case will be no less than \$60,000. I expect the Commission will direct NLU to spread these rate case costs over several years rather than permit NLU to reflect them as an expenses in the years the costs are actually incurred.

Q 41: Can you explain the line items that appear below the subheading: Other Payments?

Ans. Yes. The first six line items show amounts NLU expects to expend for the purposes described. For example, the costs associated with the renovation or replacement of the water tower are show as the first item under Other Payments: \$80,000 in 2004, 2005 and 2006, and then \$9,000 in subsequent years. These amounts relate to the proposed contract submitted by Utility Services Company. That proposed contract is NLU Exhibit WTC. Similar entries appear for each of the other five items in this part of the listing. For example, sewer plant renovation: \$75,000 in the years 2005-2008. Rate revenue must be sufficient to pay all of these items.

Q 42: How is the revenue generated by the Main Replacement Charge accounted for in this exhibit?



Ans. As I explained, the income expected from the Main Replacement Charge is shown as a separate line item in the part of the exhibit that reports income. However, these receipts are not to be used to pay debts and obligations of NLU. The line "To Line Replacement Reserve" subtracts the Main Replacement Revenue from what would otherwise be counted as income to NLU. This amount is then reflected in the line "Balance, Main Replacement Reserve." As you can see, the amount for 2004 is \$79,200. The balance in this separate account increases in subsequent years by two factors: Earned interest (at 4.5%) and additional Main Replacement Revenue. Thus, in 2005, the balance is \$161,964. This reflects the \$79,200 of Main Replacement Charge revenue in 2005, plus interest earned on the balance at January 1, through December 31, 2005. The separate account grows by this process in each successive year.

Q 43: Does this exhibit show any information that relates to rate of return?

Ans. It does. NLU believes its rates should be sufficient to enable it to earn a rate of return of 10.3%. Near the bottom of NLU Exhibit ISA - 2 I calculate the additional revenue that would be required if NLU were to earn a 10.3% rate of return on its original cost rate base. In 2004, the additional revenue requirement is \$91,551. In 2005, it is \$36,766, in 2006 it is \$108,555, and so on through 2010.

Q 44: Does this exhibit show the rate of return NLU would earn under the proposed rates?

Ans. It does. This is shown on the line Rate of Return, pro form (%). It is calculated by dividing Adjusted Net Income(Loss) by original cost rate base. In 2004 the rate of return is negative 6.86%. In 2005, it is 5.40%. In 2006, it is negative 0.56% and so on through 2012. I have also calculated a moving average of the yearly rate of return percentages. This is shown on the line "Average Rate of Return. Thus, in 2005, the average rate of return (2004 + 2005 divided by 2) is negative 0.73%. In 2006 the average becomes negative 0.67% and so on. For the period 2004 through 2012, the average rate of return is 4.79%

Q 45: What do the last four lines on this exhibit show?

Ans. These lines show how Adjusted Net Income (Loss) will be used to pay down the substantial amount carried as Accounts Payable in Current Liabilities on the Balance Sheet at December 31, 2003. At that date, Accounts Payable totaled \$207,887. The last three lines show how the Adjusted Net Income (Loss) is applied first to pay down the accounts payable obligation, and second to reduce the accumulated loss reported in the Retained Earnings Account (and thus increase the total equity in the Company). After the first year (2004) accounts payable to associated companies does not increase. Starting in 2005, Accounts Payable is paid down over time until the December 31, 2003-04 balance is paid off in 2010. In 2011, NLU would expect to be able to begin to recoup losses sustained during the years 1980 through 2003. The balance in the retained earnings

account at December 31, 2003 was negative \$1,285,289. An additional loss is shown for 2004. Thereafter, that account remains unchanged until 2012. On these pro forma assumptions and estimates, it will be 2012 before NLU may be able to begin to recoup the losses it has sustained over the last twenty some years. However, using the data in this exhibit, we can calculated that at January 1, 2013, the retained earnings account will still be negative \$1,089,075. In short, after nine more years, the equity of the Company would have increased by only \$196,214, and will still be substantially less than zero. At January 1, 2013 it would be negative \$189,075.

Q 46: How did you determine that 10.3% should be the target rate of return?

Ans. It is my understanding that the law requires the Commission to set rates that allow NLU the opportunity to earn a reasonable rate of return on its rate base. Therefore, the question is not whether, but how much? To determine a fair answer to the question, I researched the returns produced by alternative investments. The data I reviewed is found in the *Statistical Abstract* I cited in my prior answer. Table No. 1197 reports the rate of return for Stocks, T-Bills and Corporate Bonds over various time periods. Over the twenty-year period 1980 - 1999, Corporate Bonds earned an average rate of return of 10.51%. The rate of return for stocks was 17.88% (adjusted for inflation, it was 13.35%). T-Bills earned 7.04 (they are, however, guaranteed by the US government and, therefore, assumed to be nearly risk free). I felt a regulated public utility should earn a rate of return at least in line with the return on corporate bonds: 10.51%. I also calculated the average for all three types of investment: Stocks, Corporate Bonds and T-Bills. The average, using the return for stocks that is not adjusted for inflation, was 11.81%. The average, using the return for stocks that was adjusted for inflation, was 10.3%. On this basis, I determined that 10.3% was a reasonable target rate of return for NLU.

Q 47: Can you describe NLU Exhibit CRB?

Ans. Yes. NLU Exhibit CRB is a Comparative Rate Base Analysis. It is my understanding that in recent years the Commerce Commission has used original cost of plant facilities when it calculates the revenue required to generate a reasonable return on rate base. The decision to use the original cost rate base represents a change from prior practice when the Commission used the fair value rate base to calculate the revenue required to generate a reasonable return on rate base. There are many Illinois court decisions that require the use of the fair value rate base. I have been unable to find an Illinois court decision that approves the Commission's decision to abandon "fair value" and use "original cost." Exhibit CRB provides the data upon which a fair value rate base can be calculated. The exhibit includes information that explains the calculations. The purpose of the exhibit is to make a record on this point. While NLU believes Illinois law requires use of a fair value rate base, NLU Exhibit ISA - 2 uses original cost rate base to calculate the rate of return that would be realized under the assumptions used in that exhibit. NLU does not concede, however, that fair value is no longer the legally required method to determine

rate base.

Q 48: Why is NLU filing under the standard Rate Case Procedures instead of the Short Form Procedures that are available for small utilities?

Ans. I wish to point out that NLU did file under the Short Form Procedures. That filing was made on May 30, 2003. We felt that it would be much less expensive to use the Short Form Procedure. We decided, however, that it would be prudent to withdraw that filing. The reasons we decided to withdraw are no a secret. We understood that a group of our customers felt very strongly that there should be a public hearing, with witnesses required to testify under oath, rather than a public meeting, where Commission staff invited customers to speak about NLU. Mr. Lowe, as attorney for the Lost Nation Property Owners' Association, expressed that concern to the Commission shortly after our Short Form filing. We did not object to a public hearing. But the Short Form Procedure simply does not provide for a public hearing. In addition, we were concerned that the rates suggested by the Staff (after completion of their work in the Short Form case) might still be suspended by the Commission, which would initiate a Standard Form rate case - the very thing those who use the Short Form Procedure seek to avoid. That Standard Form case would not begin until after the Short Form case was completed. Because there is no time limitation on when a Short Form case must be concluded, the wait for a final rate order could be comparatively longer, depending on other matters that might require the attention of the Commission staff. We were also aware that under the Short Form Procedure, there is no opportunity to seek mediation of disputed adjustments made by Staff to the Utility's revenue requirements. This could work to the disadvantage of the Utility. Once we decided to withdraw the Short Form case, it made more sense to wait until 2004 to file the Standard Form case. This would make 2003 the logical "test year." To use 2003 as the test year would mean that any rates approved by the Commission would likely be based on data and information that was more recent (*i.e.*, more current) than the data and information NLU used to prepare the exhibits it filed in its Short Form case.

Q 49: Do you ask that the schedules and other documents NLU filed on September 3, 2004 be considered exhibits in this case?

Ans. Yes. I ask that the proposed rates, rules, regulations and conditions of service set forth in the schedules and other documents NLU filed in September be marked as NLU Exhibit PR. I prepared the schedules and documents that comprise NLU Exhibit PR.

Q 50: Does this conclude your initial testimony in this case?

Ans. Yes.

NEW LANDING UTILITY, INC.

List of NLU Exhibits  
Described in Testimony of  
Gene L. Armstrong  
(September 20, 2004)

<u>NLU Exhibit</u>	<u>Description</u>
NLU PN	Public Notice(s)
NLU WTC	Water Tower Contract (proposed)
NLU WS-1	Written Summation in <i>EPA v. NLU</i> No. 00 CH 97
NLU WS-2	References to Record in <i>EPA v NLU</i> No. 00 CH 97
NLU SMRC	Addresses Subject to Surcharge and Main Replacement Charge
NLU CBS	Comparative Balance Sheet: 2000 - 2003
NLU ISA-1	Income Statement Analysis: 2001 - 2003
NLU ISA-2	Income Statement Analysis, Pro Forma: 2004 - 2012
CRB	Comparative Rate Base study
PR	Proposed Rates, Rules, Regulations and Conditions of Service Water Service and Sewer Service (as filed on September 3, 2004)